Question #1 of 60

A) Item i.

Explanation

Item (i) is a likely violation of the Code and Standards. Working as a waitress is not a conflict of interest for an investment analyst, but Cooken's employer can reasonably assume that a 30-hour-a-week side job could be tiring, depriving the company of her skills and ability during her internship, which would violate Standard IV(A) Loyalty (to employer).

Cooken's description of the CFA exam is accurate, and she takes no liberties with a title. Thus she has not violated Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program.

One conviction as a teenager before working as an investment professional is not a violation of Standard I(D) Misconduct. Standard IV(A) Loyalty (to employer) does not hold when illegal activities are involved, and Cooken's willingness to talk to the FBI would most likely not be considered a violation. The Standards do suggest, however, that the member consult with his employer's compliance personnel or outside counsel before disclosing any confidential client information.

For Further Reference:
Study Session 1, LOS 2.a
SchweserNotes: Book 1 p.5
CFA Program Curriculum: Vol.1 p.21

Question #2 of 60

C) In college, Cooken worked for Mocline but never declared the income on her taxes.

Explanation

While Cooken's tax avoidance may represent a professional-conduct issue, it has no bearing on her ability to write a report on Mocline. While Clarrison may be an expert on Mocline Tobacco, Cooken does not know enough about the stock to write about it without taking the risk of being in violation of Standard V(A) Diligence and Reasonable Basis. Because of Cooken's relationship to the CFO of Mocline and ownership of Mocline stock, her objectivity might be questioned.

For Further Reference:
Study Session 1, LOS 2.a
SchweserNotes: Book 1 p.5
CFA Program Curriculum: Vol.1 p.21

Question #3 of 60

A) no Standards.

Explanation

Standard IV(A) Loyalty (to employer) requires that members and candidates act for the benefit of their employer and not deprive the employer of their skills and abilities. In addition, members and candidates must not cause harm to their employers. It's safe to say that a bar does not compete with a stock-analysis company, and a 6-hour-a-week part-time job should not interfere with her ability to perform analysis duties. Standard IV(B) Additional Compensation Arrangements relates to additional compensation related to an employee's services to the employer. The moonlighting is not related to her analysis job and, as such, does not violate the standard. There is nothing inherently unethical about working as a bartender, and moonlighting as a barkeeper does not

compromise Cooken's professional reputation, integrity, or competence. Thus, Standard I(D) Misconduct has not been violated.

For Further Reference:
Study Session 1, LOS 2.a
SchweserNotes: Book 1 p.5
CFA Program Curriculum: Vol.1 p.21

Question #4 of 60

C) Request 3.

Explanation

Request 3 is a likely violation. Potential clients are not entitled to performance data beyond what the company chooses to disclose. Providing data, particularly client-specific data, could be a violation of the clients' confidentiality.

Members and candidates must answer questions asked by CFA Institute's Professional Conduct Program. Members and candidates may report illegal activities (and in some cases may have a legal obligation to report such activities) on the part of clients without fear of violating Standard III(E) Preservation of Confidentiality, so 1 is not likely a violation. And unless the firm's policy requires silence about job openings, answering questions about them is ethical, if not always wise, so 2 is not likely a violation.

For Further Reference:
Study Session 1, LOS 2.a
SchweserNotes: Book 1 p.5
CFA Program Curriculum: Vol.1 p.21

Question #5 of 60

A) No, because Zonding neglected to discuss Orlando's suitability as an investment.

Explanation

Although Zonding directed the audience to his published report, the ROS also recommends that, during any public appearances, sufficient information be included for investors to assess the appropriateness of the investment for their own personal risk profile.

For Further Reference:
Study Session 1, LOS 3.b
SchweserNotes: Book 1 p.81
CFA Program Curriculum: Vol.1 p.212

Question #6 of 60

A) No.

Explanation

Zonding recommended that viewers sell shares on share price increases despite his 12-month buy rating. Firms should not allow analysts to suggest trading actions that differ from the current published rating.

For Further Reference:
Study Session 1, LOS 3.b
SchweserNotes: Book 1 p.81
CFA Program Curriculum: Vol.1 p.212

Question #7 of 60

B) must segregate analysts reporting to Scott from the investment banking department.

Explanation

The CFA Institute Research Objectivity Standards require that research analysts be separated from the investment banking department. The firm must not allow Vrbenic to report to Sheffield, the head of investment banking, in order to avoid compromising the independence of Vrbenic's analysis.

For Further Reference:
Study Session 1, LOS 3.b
SchweserNotes: Book 1 p.81
CFA Program Curriculum: Vol.1 p.212

Question #8 of 60

B) has encountered a financial hardship.

Explanation

The requirement is that firms have policies and procedures covering employees' personal investments and trading activities. These policies must prohibit employees and their immediate families from trading contrary to recently published recommendations, except in cases of extreme hardship. Since the analyst needs the money to pay for her father's kidney transplant, Verhallen may sell the securities contrary to the recommendation.

For Further Reference:
Study Session 1, LOS 3.b
SchweserNotes: Book 1 p.81
CFA Program Curriculum: Vol.1 p.212

Question #9 of 60

B) because the standards require a reasonable basis for research recommendations.

Explanation

Research analysts must be prohibited from promising a subject company a favorable report or price target or threatening to change reports, recommendations, or price targets. Sheffield's unique insight may or may not lead to a change in recommendation, but changing the recommendation based on whether the subject company does investment banking business violates the ROS. The ROS require that all conflicts of interest be disclosed but they do not prohibit coverage of companies where such a conflict of interest may be present.

For Further Reference:
Study Session 1, LOS 3.b
SchweserNotes: Book 1 p.81
CFA Program Curriculum: Vol.1 p.212

Question #10 of 60

C) be based on measurable criteria for quality of research.

Explanation

Firms must establish and implement salary, bonus, and other compensation programs that are tied to the quality of the research and the accuracy of the recommendations over time (not

necessarily every quarter). Firms must avoid directly linking analyst compensation to investment banking or corporate finance activity on which the analyst may be collaborating.

For Further Reference:
Study Session 1, LOS 3.b
SchweserNotes: Book 1 p.81
CFA Program Curriculum: Vol.1 p.212

Question #11 of 60

A) disclose her position in the securities but not by failing to provide a copy of the research that she discussed.

Explanation

Firms must provide full and fair disclosure of all potential conflicts of interest. Vrbenic's failure to disclose her position in the securities violates the ROS. Vrbenic is not, however, required to provide research to audience members, although the ROS recommends that the firm make the reports available even if they charge for them. The standards recommend-but do not require-that firms disclose availability of subject company research reports and how the audience might acquire such a report, if the firm makes it available to non-clients. This firm does not.

For Further Reference:
Study Session 1, LOS 3.b
SchweserNotes: Book 1 p.81
CFA Program Curriculum: Vol.1 p.212

Question #12 of 60

C) on a regular and timely basis.

Explanation

In order to comply with the CFA Institute Research Objectivity Standards *recommendations*, firms should issue research reports at least quarterly, or whenever material facts about the subject company change if sooner. However, there is no specific frequency of report issuance required by the Research Objectivity Standards. The only *requirement* is that firms issue their research on a regular and timely basis.

For Further Reference:
Study Session 1, LOS 3.b
SchweserNotes: Book 1 p.81
CFA Program Curriculum: Vol.1 p.212

Question #13 of 60

B) be properly supervised by the government.

Explanation

While ability of the self-regulating organizations (SROs) and their enforcement powers are important, the most important element is being properly supervised by formal government authorities.

For Further Reference:
Study Session 4, LOS 15.b
SchweserNotes: Book 1 p.299
CFA Program Curriculum: Vol.1 p.681

Question #14 of 60

B) appreciate.

Explanation

Given low capital mobility, a restrictive monetary and fiscal policy should lead to domestic currency appreciation under the Mundell-Fleming model.

For Further Reference:
Study Session 4, LOS 13.l
SchweserNotes: Book 1 p.257
CFA Program Curriculum: Vol.1 p.555

Question #15 of 60

B) technological growth.

Explanation

Under the neoclassical growth theory, capital deepening affects the level of output but not the growth rate in the long run. Once an economy reaches steady-state growth, only further technological progress will increase the growth rate.

For Further Reference:
Study Session 4, LOS 14.i
SchweserNotes: Book 1 p.286
CFA Program Curriculum: Vol.1 p.636

Question #16 of 60

A) GBP/SFr = 0.4271 - 78.

Explanation

GBP/SFr = GBP/USD × USD/SFr.

We are given USD/GBP, so we convert the provided quotes:

$$\left(\frac{GBP}{USD}\right)_{bid} = \frac{1}{\left(\frac{USD}{GBP}\right)_{offer}} = \frac{1}{2.0020} = 0.4995$$

and

$$\left(\frac{GBP}{USD}\right)_{offer} = \frac{1}{\left(\frac{USD}{GBP}\right)_{bid}} = \frac{1}{2.0010} = 0.4998$$

Now,

$$\left(\frac{GBP}{SFr}\right)_{bid} = \left(\frac{GBP}{USD}\right)_{bid} \times \left(\frac{USD}{SFr}\right)_{bid} = 0.4995 \times 0.8550 = 0.4271$$

and

$$\left(\frac{GBP}{SFr}\right)_{offer} = \left(\frac{GBP}{USD}\right)_{offer} \times \left(\frac{USD}{SFr}\right)_{offer} = 0.4998 \times 0.8560 = 0.4278$$

The GBP/SFr quote should be: GBP/SFr = 0.4271 − 78.

For further reference:
Study Session 4, LOS 13.b

SchweserNotes: Book 1 p.233
CFA Program Curriculum: Vol.1 p.503

Question #17 of 60

A) USD 860.

Explanation

The original 60-day forward contract calls for long GBP. So the all-in forward price FP = 2.0085. After 30 days, the contract would still have 30 days remaining to expiration. The new 30-day all-in forward price to sell GBP is 2.0086 +(7.6/10,000) = 2.00936. The relevant 30-day USD interest rate is 4%.

$$V_t = \frac{(FP_t - FP)(\text{Contract size})}{\left[1 + R\left(\frac{\text{Days}}{360}\right)\right]} = \frac{(2.00936 - 2.0085)(1{,}000{,}000)}{\left[1 + 0.04\left(\frac{30}{360}\right)\right]} = \text{USD } 857.14$$

For further reference:
Study Session 4, LOS 13.d
SchweserNotes: Book 1 p.239
CFA Program Curriculum: Vol.1 p.512

Question #18 of 60

B) $31.50.

Explanation

Covered interest rate parity requires that $\frac{F}{S} = \frac{(1 + R_{\$})}{(1 + R_{BU})}$

$$\frac{F}{S} = \frac{2.10}{2.00} = 1.05$$

$$\frac{(1 + R_{\$})}{(1 + R_{BU})} = \frac{(1 + 0.05)}{(1 + 0.03)} = 1.019$$

The BUN should appreciate by 1.9% per year. However, in the forward market, the BUN is trading at a premium of 5%. Therefore, the appropriate arbitrage strategy is to sell BUN in the forward market as below:

1. Borrow $1,000 at 5%. At the end of one year, Williams will be obligated to repay $1,000(1.05) = $1,050.
2. Convert the $1,000 to BUN at the spot rate, which yields $1,000 / ($2/BUN) = BUN500.
3. Simultaneously enter into a 1-year forward contract to convert BUN to USD at the forward rate of $2.1000/BUN.
4. Invest BUN 500 at 3%. In one year, Williams will receive proceeds of BUN500(1.03) = BUN515.
5. Convert the BUN515 back to USD at the forward rate, which was locked in at the beginning of the year and yields BUN 515($2.1/BUN) = $1,081.50.
6. Arbitrage profits = $1,081.50 - $1,050 = $31.50.

For further reference:
Study Session 4, LOS 13.e
SchweserNotes: Book 1 p.242
CFA Program Curriculum: Vol.1 p.518

Question #19 of 60

B) The decrease in accounts payable in 2013 increased the quality of cash flow as High Plains is paying off suppliers more rapidly.

Explanation

In Exhibit 1, the cash flow statement shows that payables contributed positively to cash flow for 2013. This means payables increased during the period, suggesting High Plains was *delaying* payments to suppliers to boost CFO.

For Further Reference:
Study Session 6, LOS 19.i
SchweserNotes: Book 2 p.112
CFA Program Curriculum: Vol.2 p.237

Question #20 of 60

A) Both net income and inventory turnover are overstated.

Explanation

Revenue should be recognized when earned and payment is assured. High Plains is recognizing revenue as orders are received. Because High Plains has not yet fulfilled its obligation to deliver the goods, revenue is not yet earned. By recognizing revenue too soon, net income is overstated and ending inventory is understated. Understated ending inventory would result in an overstated inventory turnover ratio.

For Further Reference:
Study Session 6, LOS 19.h
SchweserNotes: Book 2 p.109
CFA Program Curriculum: Vol.2 p.223

Question #21 of 60

A) more than 20% of net income in 2014.

Explanation

Net income		$158,177,000
Bill-and-hold revenue	$907,950,000	
EBT margin	5.1%	
Bill-and-hold pre-tax income	$46,305,450	
Tax rate	28%	
Bill-and-hold post-tax income		$33,339,924
		21.08%

For Further Reference:
Study Session 6, LOS 19.h
SchweserNotes: Book 2 p.109
CFA Program Curriculum: Vol.2 p.223

Question #22 of 60

A) High Plains' discretionary expenses.

Explanation

Discretionary expenses, such as maintenance and repairs, and advertising and marketing expenses, are declining over time even as sales and capital expenditures are increasing. Investment in capital assets is increasing because cash flow from investing activities (CFI) is greater than depreciation expense for the period. The change to the straight-line depreciation method is certainly less conservative. However, measuring earnings quality based on conservative earnings is an inferior measure as most accruals will correct over time. Note that using LIFO as an inventory cost flow assumption during periods of stable or rising prices would cause net earnings to reflect economic (real) earnings, thereby leading to a higher quality of earnings.

For Further Reference:
Study Session 6, LOS 19.f
SchweserNotes: Book 2 p.107
CFA Program Curriculum: Vol.2 p.214

Question #23 of 60

C) Only the treatment in footnote 7 lowers financial reporting quality.

Explanation

A finance (capital) lease is reported on the balance sheet as an asset and as a liability. In the income statement, the leased asset is depreciated and interest expense is recognized on the liability. Thus, capitalizing a lease *enhances* earnings quality. An *operating* lease classification *lowers* earnings quality. The reclassification of inventory will impact the calculation of inventory turnover and inventory days. Reclassifications make trend analysis more difficult and lower financial reporting quality.

For Further Reference:
Study Session 6, LOS 19.d
SchweserNotes: Book 2 p.104
CFA Program Curriculum: Vol.2 p.210

Question #24 of 60

C) Due to High Plains' lengthy credit terms for customers, analysts should place a higher weighting on the accruals-based element of earnings rather than the cash-based element.

Explanation

It appears that High Plains manipulated its earnings in 2014 to avoid default under its bond covenants. Extreme earnings (including revenues) tend to revert to normal levels over time (mean reversion). Because of the estimates involved, a *lower* weighting should be assigned to the accrual component of High Plains' earnings.

For Further Reference:
Study Session 6, LOS 19.g
SchweserNotes: Book 2 p.109
CFA Program Curriculum: Vol.2 p.222

Question #25 of 60

A) Pension expense and the cash funding amount would be the same.

Explanation

In a defined contribution plan, pension expense is equal to the amount contributed by the firm. The plan participants bear the shortfall risk. There is no pension obligation in a defined contribution plan.

For Further Reference:
Study Session 5, LOS 17.a
SchweserNotes: Book 2 p.36
CFA Program Curriculum: Vol.2 p.73

Question #26 of 60

C) No adjustment is necessary.

Explanation

Under U.S. GAAP and under IFRS, Global Oilfield would report the funded status in its balance sheet.

For Further Reference:
Study Session 5, LOS 17.b
SchweserNotes: Book 2 p.37
CFA Program Curriculum: Vol.2 p.75

Question #27 of 60

C) Increase in the discount rate.

Explanation

The assumed discount rate increased from 6.25% in 20X7 to 6.75% in 20X8 (Exhibit 4). There is an inverse relationship between the discount rate and the present value of a future sum. Thus, the increase in the discount rate resulted in an actuarial gain (lower PBO). An increase in life expectancy would result in an actuarial loss. Decrease in expected rate of return would increase reported pension expense but would not affect PBO.

For Further Reference:
Study Session 5, LOS 17.d
SchweserNotes: Book 2 p.46
CFA Program Curriculum: Vol.2 p.81

Question #28 of 60

C) net income is higher and the funded status is higher.

Explanation

A decrease in the compensation growth rate will reduce service cost. Lower service cost will result in lower pension expense and, thus, higher net income. Lowering the compensation growth rate will also reduce the PBO. A lower PBO will increase the funded status of the plan (make the plan appear more funded). The compensation growth rate assumption has no effect on the plan assets.

For Further Reference:
Study Session 5, LOS 17.d
SchweserNotes: Book 2 p.46
CFA Program Curriculum: Vol.2 p.81

Question #29 of 60

B) lower.

Explanation

For the year-ended 20X8, Global Oilfield's reported pension expense was €8,028 (Exhibit 3), and its total periodic pension cost was €3,410. Total periodic pension cost can be calculated as plan contributions minus the change in funded status [€5,000 - (€2,524 funded status for 20X8 - €934 funded status for 20X7)].

For Further Reference:
Study Session 5, LOS 17.f
SchweserNotes: Book 2 p.50
CFA Program Curriculum: Vol.2 p.97

Question #30 of 60

A) Increase operating cash flow €750 and decrease financing cash flow €750.

Explanation

Total periodic pension cost represents the true cost of the pension. If the firm's contributions exceed its true pension expense, the difference can be viewed as a reduction in the overall pension obligation similar to an excess principal payment on a loan. Pension contributions are reported as operating activities in the cash flow statement while principal payments are reported as financing activities. Thus, the adjustment involves increasing operating cash flow by €750 (€5,000 employer contributions - €4,250 total periodic pension cost) and decreasing financing cash flow by the same amount.

For Further Reference:
Study Session 5, LOS 17.e
SchweserNotes: Book 2 p.48
CFA Program Curriculum: Vol.2 p.88

Question #31 of 60

B) $119 million.

Explanation

Consolidated current assets are equal to $119 million ($96 Valley current assets − $9 cash for investment in Southwest + $32 Southwest current assets).

For Further Reference:
Study Session 5, LOS 16.a
SchweserNotes: Book 2 p.1
CFA Program Curriculum: Vol.2 p.10

Question #32 of 60

C) No Yes

Explanation

ROA is calculated as net income / total assets. Both methods result in the same net income, so conclusion 1 is incorrect. However, the acquisition method leads to higher reported total assets. Hence, the ROA is greater under the equity method and lower under the acquisition method (conclusion 2 is correct).

For Further Reference:
Study Session 5, LOS 16.b
SchweserNotes: Book 2 p.1
CFA Program Curriculum: Vol.2 p.10

Question #33 of 60

C) Two.

Explanation

The applicability of equity method and acquisition method is identical under U.S. GAAP and IFRS (convergence project) and hence statement 1 is correct. While equity method reports the same net income as acquisition (statement 2 is correct), due to the inclusion of minority interest in equity under the acquisition method, the amount of equity reported under the acquisition method is higher than the amount of equity reported under the equity method (statement is 3 incorrect).

For Further Reference:
Study Session 5, LOS 16.b
SchweserNotes: Book 2 p.1
CFA Program Curriculum: Vol.2 p.10

Question #34 of 60

C) $1,445.

Explanation

See the table in the solution to the next question.

The following financial statements reflect the use of the current rate method (functional currency is the CHF) since Mountain is a self-contained company and is less dependent on Valley.

Income statement (in $ thousands)		
Sales	$5,600	= 0.80 × 7,000
Cost of goods sold	$5,440	= 0.80 × 6,800
Depreciation	80	= 0.80 × 100
Net income	$80	
<="" td="">		

Balance sheet (in $ thousands)		
Cash and accounts receivable	$510	= 0.85 × 600
Inventory	425	= 0.85 × 500
Fixed assets	510	= 0.85 × 600
Total assets	$1,445	
<="" td="">		
Accounts payable	$170	= 0.85 × 200
Long-term debt	85	= 0.85 × 100
Common stock	1,001	= 0.77 × 1,300
Retained earnings	80	= 0 + 80
FC translation adjustment	109	Calculated as plug figure
Total liabilities and equity	$1,445	

For Further Reference:
Study Session 5, LOS 18.d, e
SchweserNotes: Book 2 p.63, 69
CFA Program Curriculum: Vol.2 p.134, 143

Question #35 of 60

C) $109.

Explanation

The following financial statements reflect the use of the current rate method (functional currency is the CHF) since Mountain is a self-contained company and is less dependent on Valley.

Income statement (in $ thousands)

Sales	$5,600	= 0.80 × 7,000
Cost of goods sold	$5,440	= 0.80 × 6,800
Depreciation	80	= 0.80 × 100
Net income	$80	

Balance sheet (in $ thousands)

Cash and accounts receivable	$510	= 0.85 × 600
Inventory	425	= 0.85 × 500
Fixed assets	510	= 0.85 × 600
Total assets	$1,445	
Accounts payable	$170	= 0.85 × 200
Long-term debt	85	= 0.85 × 100
Common stock	1,001	= 0.77 × 1,300
Retained earnings	80	= 0 + 80
FC translation adjustment	109	Calculated as plug figure
Total liabilities and equity	$1,445	

For Further Reference:
Study Session 5, LOS 18.d, e
SchweserNotes: Book 2 p.63, 69
CFA Program Curriculum: Vol.2 p.134, 143

Question #36 of 60

A) nonmonetary assets and nonmonetary liabilities are adjusted for inflation in accordance with U.S. GAAP.

Explanation

Under U.S. GAAP, the nonmonetary assets and liabilities of the foreign subsidiary are not restated for inflation. Under IFRS, the subsidiary's financial statements are adjusted for inflation, and the net purchasing power gain or loss is recognized in the income statement. Then, the subsidiary is translated into U.S. dollars using the current rate method. If Mountain operates in a highly inflationary environment, the appropriate method is the temporal method. Under the temporal method, the functional currency is considered to be the parent's presentation currency. Thus, Mountain's functional currency is the U.S. dollar.

For Further Reference:
Study Session 5, LOS 18.g
SchweserNotes: Book 2 p.81
CFA Program Curriculum: Vol.2 p.140

Question #37 of 60

B) Subsidiary Horizontal

Explanation

Ozer's memo states that in an acquisition, Alertron would want to maintain the successful Escarigen brand and operational structure. As a result, the most likely form of integration would be a subsidiary merger in which Escarigen would become a subsidiary of Alertron. Most subsidiary mergers occur when the target has a well-known brand that the acquirer wants to maintain, which is the case here. Note that in a statutory merger, the target company would cease to exist as a separate entity. Since both Alertron and Escarigen are involved in the pharmaceutical industry, the type of merger would be best described as horizontal. The merger would not be vertical as Alertron would not be moving up or down the supply chain.

For Further Reference:
Study Session 8, LOS 26.a
SchweserNotes: Book 2 p.275
CFA Program Curriculum: Vol.3 p.253

Question #38 of 60

B) Carideo would likely avoid paying corporate taxes in the potential deal with Alertron.

Explanation

The potential acquisition of Carideo is described as a stock purchase, which means that Carideo's shareholders would be responsible for paying capital gains taxes on the deal and no taxes would be levied against Carideo at the corporate level. The other answers are incorrect. The potential deal with Escarigen is described as a cash offering. In most cash offerings, the acquirer borrows money to raise cash for the deal, which would increase the acquirer's financial leverage. In the potential deal with BriscoePharm, shareholders generally only approve asset purchases when the purchase is substantial (greater than 50% of firm assets). In this case, shareholder approval would not be required. In a proxy battle for Dillon Biotech, Alertron would try to have shareholders approve new members of the board of directors to try to gain control of the company. Trying to purchase shares from shareholders individually is a tender offer.

For Further Reference:
Study Session 8, LOS 26.e
SchweserNotes: Book 2 p.281
CFA Program Curriculum: Vol.3 p.262

Question #39 of 60

C) Supermajority voting provision Leveraged recapitalization

Explanation

The only pair combination that correctly identifies a pre-offer and post-offer defense, respectively, is a supermajority voting provision, which is a pre-offer defense requiring shareholder approval in excess of a simple majority; and a leveraged recapitalization, which is a post-offer defense where a target borrows money to repurchase its own shares. Pre-offer defenses suggested include poison puts, fair price amendments, restricted voting rights, poison pills, and staggered board

elections. The only other post-offer defense suggested was greenmail, which was incorrectly categorized.

For Further Reference:
Study Session 8, LOS 26.f
SchweserNotes: Book 2 p.284
CFA Program Curriculum: Vol.3 p.267

Question #40 of 60

C) $514.2 million.

Explanation

First, calculate the value of the combined firm after the merger:

Post merger value of the combined firm: $V_{AT} = V_A + V_T + S - C$

$V_A = \$9,000$
$V_T = \$3,120$
$S = \$600$
$C = \$0$ because no cash is changing hands
The value of the combined firm is therefore $V_{AT} = \$9,000 + \$3,120 + \$600 - 0 = \$12,720$

Next, to account for the dilution and to find the price per share for the combined firm, P_{AT}, divide the post merger value by the post merger number of shares outstanding. Since we are told that Alertron would exchange 0.75 shares of its stock for each share of Carideo, the number of new shares issued is:

80 million shares × 0.75 = 60 million new shares

So, $P_{AT} = \dfrac{\$12,720}{150 + 60} = \$60.57$

This means the actual value of each share given to Carideo''s shareholders is $60.57 and the actual price paid for Carideo is:

$P_T = (N \times P_{AT}) = (60 \times \$60.57) = \$3,634.20$

Carideo''s gain in the merger as the target is:

$Gain_T = TP = P_T - V_T = \$3,634.20 - \$3,120 = \$514.20$

Note that Carideo''s gain simply represents the takeover premium in the transaction.

For Further Reference:
Study Session 8, LOS 26.k
SchweserNotes: Book 2 p.302
CFA Program Curriculum: Vol.3 p.288

Question #41 of 60

A) Both firms prefer a cash deal.

Explanation

In a cash offer, the acquirer assumes the risk and receives the potential reward from the merger, while the gain to the target shareholders is limited to the takeover premium. In this case, Alertron is comfortable with the estimate of synergies and thinks the estimate may even be conservative. By making a cash offer, the takeover premium realized by Carideo would remain unchanged,

with any excess benefit from synergies going to Alertron. Based on its forecasts, Alertron would prefer a cash deal.

However, if the synergies were less than expected, the takeover premium realized by Carideo would still be unchanged with a cash deal, but Alertron's gain may decrease. Since Carideo management believes the estimate of synergies is too high, they would also prefer a cash deal to lock in the gain they realize from the takeover premium.

For Further Reference:
Study Session 8, LOS 26.l
SchweserNotes: Book 2 p.306
CFA Program Curriculum: Vol.3 p.289

Question #42 of 60

C) 300 Potential antitrust challenge

Explanation

Pre-merger HHI = $(0.20 \times 100)^2 + (0.18 \times 100)^2 + (0.15 \times 100)^2 + (0.12 \times 100)^2 + (0.10 \times 100)^2 + (0.07 \times 100)^2 + [(0.03 \times 100)^2 \times 6] = 1{,}296$

The post merger market share of the combined firms would be 15% + 10% = 25%.

Post-merger HHI = $(0.25 \times 100)^2 + (0.20 \times 100)^2 + (0.18 \times 100)^2 + (0.12 \times 100)^2 + (0.07 \times 100)^2 + [(0.03 \times 100)^2 \times 6] = 1{,}596$

Change in HHI = 1,596 − 1,296 = 300

A post-merger HHI that is between 1,000 and 1,800 indicates a moderately concentrated industry. With a change in an HHI that is greater than 100, there is certainly the potential for an antitrust challenge by regulators.

For Further Reference:
Study Session 8, LOS 26.g
SchweserNotes: Book 2 p.287
CFA Program Curriculum: Vol.3 p.274

Question #43 of 60

C) only benefit 2 is accurate.

Explanation

Benefit 1 is incorrect. Depending on the level of earnings versus positive NPV projects available, the dividend can swing from very high to low (or zero). Positive NPV projects will be financed using earnings, and there will be no dividend if all earnings are used in this way.

For Further Reference:
Study Session 7, LOS 23.f
SchweserNotes: Book 2 p.225
CFA Program Curriculum: Vol.3 p.146

Question #44 of 60

B) $2,230,000.

Explanation

Debt	Short-term	120		
	Long-term	74,953		
	Total		**75,073**	
Equity	Common stock	200,458		
	APIC	224,909		
	Total		**425,367**	
Capital structure		Debt	**15.00%**	75,073 / (75,073 + 425,367)
		Equity	**85.00%**	425,367 / (75,073 + 425,367)
Capital expenditure		28,000		
Financed by debt		4,200	28,000 × 0.15	
Financed by earnings		23,800	28,000 × 0.85	
Earnings for year		26,034		
Required by capex		23,800		
Residual Dividend		**2,234**		

For Further Reference:
Study Session 7, LOS 23.f
SchweserNotes: Book 2 p.225
CFA Program Curriculum: Vol.3 p.146

Question #45 of 60

C) $2,570,000

Explanation

			Outlay
Proceeds from sale	2,200,000		**2,200,000**
Tax base	0	(full allowance in year 1)	
Taxable gain	2,200,000		
Tax rate	35%		
Tax payable	770,000		**(770,000)**
Cost new machine	3,800,000		**(3,800,000)**
Investment in working capital	200,000		**(200,000)**
Net outlay			**(2,570,000)**

Note that investment in working capital is not tax deductible. Annual tax allowable depreciation on the new machine would be relevant when calculating the tax paid for operating cash flows (at the end of the year).

For Further Reference:
Study Session 7, LOS 21.a

SchweserNotes: Book 2 p.154
CFA Program Curriculum: Vol.3 p.27

Question #46 of 60

A) 16.2%

Explanation

All equity cost	15%						
Cost of debt	8%						
Current D/E	0.18	Debt	75,073	New D/E	0.27	Debt	115,073
Tax Rate	35%	Equity	425,367			Equity	425,367

$r_e = r_o + [(r_o - r_d) \times (1\text{-}t) \times (D/E)]$

$= 15\% + [(15\% - 8\%) \times 0.65 \times 0.27]$

$= 16.2\%$

For Further Reference:
Study Session 7, LOS 22.a
SchweserNotes: Book 2 p.199
CFA Program Curriculum: Vol.3 p.94

Question #47 of 60

A) Correct.

Explanation

The costs of financial distress will indeed be lower if the company has tangible, marketable assets, compared to a company with mostly intangible assets.

For Further Reference:
Study Session 7, LOS 22.a
SchweserNotes: Book 2 p.199
CFA Program Curriculum: Vol.3 p.94

Question #48 of 60

A) the pecking order theory.

Explanation

The pecking order theory suggests that managers prefer to finance internally as it has the lowest potential information content, followed by debt and finally new equity.

For Further Reference:
Study Session 7, LOS 22.a
SchweserNotes: Book 2 p.199
CFA Program Curriculum: Vol.3 p.94

Question #49 of 60

A) 8.40% 10.25%

Explanation

Based on the APT, the appropriate discount rate for Trailblazer is:
$E(R_{Trailblazer})$ = 3.5% + (0.81 × 1.91%) − (0.45 × 1.22%) + (0.24 × 3.47%) + (0.74 × 4.15%) = 8.4%

Based on the BYPRP method, the required return on Trailblazer's equity = 7.25% + 3% = 10.25%.

For Further Reference:
Study Session 9, LOS 28.c
SchweserNotes: Book 3 p.19
CFA Program Curriculum: Vol.4 p.69

Question #50 of 60

A) 1.2%.

Explanation

Equity risk premium = dividend yield + LT EPS growth rate - LT government bond yield

= 2.1% + 3.5% - 4.4% = 1.2%

For Further Reference:
Study Session 9, LOS 28.b
SchweserNotes: Book 3 p.15
CFA Program Curriculum: Vol.4 p.56

Question #51 of 60

C) Three.

Explanation

All three statements are consistent with the assumptions of the Gordon growth model. Regarding Statement 3, there is nothing to prevent the growth rate from being negative. The model can still be applied in this case.

For Further Reference:
Study Session 10, LOS 30.d
SchweserNotes: Book 3 p.69
CFA Program Curriculum: Vol.4 p.217

Question #52 of 60

B) Only Statement 4 supports the use of DDM.

Explanation

For a DDM to be appropriate for valuation purposes, dividends must be a reasonably good measure of the cash flow of a firm. Dividends are appropriate for measuring cash flow when a company has a history of dividend payments, when the dividend policy is clear and related to the firm's earnings, and when the perspective is that of a minority shareholder. The two statements relate to the history of dividends and the relationship between dividends and earnings. Statement 4 supports the use of dividends since the history of paying dividends is fairly long and consistent. Statement 5 suggests that the relationship between dividends and earnings is not very strong since the company continues to pay regular dividends regardless of whether losses are incurred or profits are earned.

For Further Reference:
Study Session 10, LOS 30.a

SchweserNotes: Book 3 p.62
CFA Program Curriculum: Vol.4 p.199

Question #53 of 60

C) Only Statement 7 is incorrect.

Explanation

Statement 6 is correct. Adjusted historical equity risk premium removes any biases in the historical data series. Statement 7 is incorrect. While we adjust peer public company beta for leverage differences, differences in size are not accounted for via adjustment to beta. It is better to account for size differences by additional risk premium for size.

For Further Reference:
Study Session 9, LOS 28.b, d
SchweserNotes: Book 3 p.15, 24
CFA Program Curriculum: Vol.4 p.56, 70

Question #54 of 60

C) 16.67 17.50

Explanation

required return = 3.5% + (1.2 × 4.5%) = 8.9%

retention ratio = b = ($4.00 − $2.60)/$4.00 = 0.35

payout ratio = (1 − b) = 1 − 0.35 = 0.65

$$\text{justified leading P/E} = \frac{1-b}{r-g} = \frac{0.65}{0.089-0.05} = 16.67$$

$$\text{justified trailing P/E} = \frac{(1-b) \times (1+g)}{(r-g)} = \frac{0.65 \times 1.05}{0.089-0.05} = 17.50$$

Notice that the current market price is irrelevant for calculating justified P/E ratios.

For Further Reference:
Study Session 10, LOS 30.f
SchweserNotes: Book 3 p.71
CFA Program Curriculum: Vol.4 p.220

Question #55 of 60

B) Only Mnoyan is correct.

Explanation

Mnoyan is correct. IFRS permits either the partial goodwill or full goodwill method to value goodwill and the noncontrolling interest under the acquisition method. U.S. GAAP requires the full goodwill method. Vadney is incorrect. Both IFRS and U.S. GAAP require equity method accounting for joint ventures.

For Further Reference:
Study Session 5, LOS 16.b
SchweserNotes: Book 2 p.1
CFA Program Curriculum: Vol.2 p.10

Question #56 of 60

B) Baste

Explanation

% Revenue growth = (1 + % ∆volume) × (1 + % ∆price) - 1

Forecasted revenue = current revenue × (1 + revenue growth rate) = $121 × (1 + revenue growth rate)

% growth in COGS = (1 + % ∆volume) × (1 + % ∆input price) - 1

Forecasted COGS = (current COGS) × (1 + COGS growth rate) = $89 × (1 + COGS growth rate)

Analyst	*Adams*	*Baste*	*Cairns*
Revenue growth	6.08%	7.10%	5.04%
COGS growth	7.12%	6.08%	6.05%
Forecasted revenues	$128.36	$129.59	$127.10
Forecasted COGS	$95.34	$94.41	$94.38
Forecasted gross margin	25.72%	27.15%	$25.74%

Current gross margin = ($121 - $89) / $121 = 26.45%

Thus, analyst Baste is most likely to forecast an improvement in gross margin.

For Further Reference:
Study Session 11, LOS 33.i
SchweserNotes: Book 3 p.214
CFA Program Curriculum: Vol.4 p.479

Question #57 of 60

C) endogenous growth theory.

Explanation

The neoclassical growth theory relates technological change to increases in labor productivity; however, increases in capital and labor would not increase growth rate in output per worker permanently under neoclassical growth theory.

The endogenous growth theory holds that technological advances lead to increases in labor productivity. Additionally, capital deepening investments would lead to social benefits and hence lead to further technological advances-increasing growth rate of output per worker.

Classical growth theory maintains that any increase in per capita GDP above subsistence level is mean reverting.

For Further Reference:
Study Session 4, LOS 14.i
SchweserNotes: Book 1 p.286
CFA Program Curriculum: Vol.1 p.636

Question #58 of 60

B) earnings divided by the required rate of return.

Explanation

The value of assets in place is E/r. The difference between this value and the fundamental value is PVGO.

For Further Reference:
Study Session 10, LOS 30.e
SchweserNotes: Book 3 p.70
CFA Program Curriculum: Vol.4 p.218

Question #59 of 60

A) 9.5%

Explanation

$$r = \left[\left(\frac{D_0}{P_0}\right)\right] \times \{(1+g_L) + [H \times (G_s - g_L)]\} + g_L$$

Given: dividend yield = 5%, g_s = 12%, g_L = 3% and H = 6/2 = 3.

r=[(0.05) × {(1.03) + 3(0.12 - 0.03)}] + 0.03 = 0.095 or 9.5%

For Further Reference:
Study Session 10, LOS 30.m
SchweserNotes: Book 3 p.85
CFA Program Curriculum: Vol.4 p.237

Question #60 of 60

C) Models are sensitive to assumptions of growth, allowing variability in potential values.

Explanation

Sensitivity to assumptions of growth is a limitation, not a strength.

For Further Reference:
Study Session 10, LOS 30.h, i
SchweserNotes: Book 3 p.74, 75
CFA Program Curriculum: Vol.4 p.223, 224